Supreme Court, U.S.
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No. 92-873

In The

Supreme Court of the United States

October Term, 1992

ALLSTATE INSURANCE COMPANY,

Petitioner,

v.

CYNTHIA M. MALESKI, Acting Insurance Commissioner of the Commonwealth of Pennsylvania, as Rehabilitator of the Mutual Fire, Marine and Inland Insurance Company,

Respondent.

Petition For Writ Of Certiorari To The Supreme Court Of Pennsylvania

BRIEF IN OPPOSITION

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COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

(1) Where Petitioner concedes that it did not argue, in the state court proceedings, that either the Pennsylvania Insurance Department Act or the Plan of Rehabilitation violates the Federal Arbitration Act, and where one of the issues in the Petition is that the Pennsylvania Insurance Department Act is in conflict with the Federal Arbitration Act, should that issue be addressed?

(2) Where the specific contract provisions relied upon by Petitioner for its Contract Clause claim were not entered into the record below, should this Court consider Petitioner's claim that the Plan impairs those contract provisions in violation of Article I, Section 10 of the United States Constitution?

(3) Where the sole issue presented is whether or not the Plan of Rehabilitation grants more restrictive rights of setoff than Petitioner would receive in a liquidation and where the Pennsylvania Supreme Court has held, based upon its interpretation of the Pennsylvania Insurance Department Act, that, with respect to setoff, the rights of creditors set forth in the Plan of Rehabilitation are the same as they would be in liquidation, should the Petition for Writ of Certiorari be denied?

(4) Where the Pennsylvania Supreme Court, in interpreting the Pennsylvania Insurance Department Act, has held that the substantive law of the Commonwealth of Pennsylvania (in the context of insurance insolvency proceedings) grants creditors the same setoff rights in rehabilitation as it does in liquidation, and where the sole issue raised in the Petition is that Petitioner will not

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receive the same rights in rehabilitation as it would in liquidation, should this Court address issues involving the state court's interpretation of substantive state law?

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COUNTERSTATEMENT OF THE CASE

Respondent is Cynthia M. Maleski, the Acting Insurance Commissioner of the Commonwealth of Pennsylvania, as Statutory Rehabilitator ("Rehabilitator") of The Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire"). On December 8, 1986, the Commonwealth Court of Pennsylvania entered an Order placing Mutual Fire into rehabilitation pursuant to the Pennsylvania Insurance Department Act (the "Act"), 40 P.S. § 221.15(a), and appointing the Insurance Commissioner of the Commonwealth of Pennsylvania as Rehabilitator pursuant to 40 P.S. § 221.15(c).[1]

Mutual Fire is a mutual insurance company which was incorporated in 1902 under the laws of the Commonwealth of Pennsylvania.[2] Before it ceased writing business in 1986, Mutual Fire's business included a broad range of property, casualty and special risks insurance, with substantial reliance upon reinsurance. Mutual Fire is licensed to do business in Pennsylvania, Delaware, New York and Puerto Rico, and operates on a surplus lines (non-admitted) basis in virtually every other state.

Article V of the Act governs the rehabilitation and liquidation of insolvent insurance companies in Pennsylvania. Its stated purpose is "the protection of the interests

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[1] Under the Pennsylvania Insurance Department Act, the Commonwealth Court is assigned jurisdiction over, and supervisory responsibility for, insurance rehabilitations and liquidations. 40 P.S. § 221.4.

[2] Mutual Fire has no parent company. Mutual Fire's subsidiaries, as defined by Sup. Ct. R. 29.1, are: Endmark Data Processing Corporation; Ryansure Intermediaries, Inc.; Cable Life Insurance Co.; UMI Asset Management and UMI Holdings.

of insureds, creditors, and the public generally" through, *inter alia*, "equitable apportionment of any unavoidable loss." 40 P.S. § 221.1(c). The Act affords the Insurance Commissioner, as statutory rehabilitator, broad discretion and authority to "take such action as [s]he deems necessary or expedient to correct the condition or conditions which constituted the grounds for the order of the court to rehabilitate the insurer." *Foster v. Mutual Fire, Marine & Inland Insurance Company*, 1992 W.L., 210948 (Pa. August 21, 1992) (A7),[3] citing 40 P.S. § 221.16(b). This includes the discretion and authority to formulate a plan for rehabilitating an insolvent insurance company. 40 P.S. § 221.16(d).

On January 31, 1989, pursuant to 40 P.S. § 221.16(d), the Rehabilitator submitted to the Commonwealth Court a Plan of Rehabilitation for Mutual Fire (the "Plan"). Various creditors, including Petitioner, filed objections to the Plan. On July 25, 26, 28, and August 1, 1989, hearings were held before the Honorable James Crumlish, Jr., then President Judge of the Commonwealth Court, to consider the proposed Plan.

A. SECTION II OF THE PLAN PROTECTS SECURED CREDITORS' RIGHTS

The Plan establishes separate classes of creditors based upon the priority of distribution set forth in 40 P.S. § 221.44. Pertinent classes include:

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[3] References to the Appendix in the Petition of Allstate are designated as "A ___."

Class 1 – Secured Cedents;

Class 2 – Administrative Claims;

Class 3 – Wage Claims;

Class 4 – Policyholder Claims (which excludes surety bond lenders, cedents and reinsurers);

Class 5 – Surety Bond lenders;

Class 6 – General Unsecured Creditor Claims (including those of cedents and reinsurers).

Petitioner Allstate both reinsured, and ceded business to, Mutual Fire.[4] To the extent that Allstate is a secured cedent (*i.e.*, Mutual Fire was required to pledge collateral to secure its obligations), it qualifies as a Class 1 creditor under the Plan.

Section II(A) of the Plan adequately protects secured cedents' rights by providing that they can draw upon their collateral (whether in the form of letters of credit or trusts) for the full amount of their approved claims. (A91-92.) Until such claims are adjusted under the Plan, Petitioner Allstate and the other secured cedents necessarily retain their liens against the collateral which they hold.

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[4] Cedents are companies whom Mutual Fire reinsures. Reinsurers are companies obligated to Mutual Fire under contracts of reinsurance, having assumed Mutual Fire business. Mutual Fire Plan, § I(4), (26) (A87, A90).

B. SECTION III OF THE PLAN PROTECTS SET-OFF RIGHTS

The Plan directs the Rehabilitator to marshal estate assets, in particular, reinsurance recoveries, which constitute the most significant and substantial asset of Mutual Fire. (Hearing Transcript, T. 40, 44.) Nevertheless, the Plan gives appropriate recognition to the traditional equitable remedy of setoff between cedents and reinsurers. Under Section III(D), mutual debts and credits, to the extent that such obligations were due and owing as of December 4, 1986 (the date on which the Insurance Commissioner filed her Petition for Rehabilitation), may be set off.[5] Thus, the Plan expressly permits creditors to exercise their right to set off matured, liquidated obligations as of the date of the filing of the Rehabilitation Petition. Case reserves as of December 4, 1986 (which are estimates of the amounts required to cover future payments on account of known claims) and IBNR as of that date (amounts predicted to be paid in the future on account of events that have occurred but have not been reported as claims) are not mutual debts under Pennsylvania law and thus, are not available for setoff.

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[5] The term "due and owing" refers to reinsurance amounts recoverable on paid Losses (*i.e.*, payments by cedents to policyholders and other claimants), paid Loss Adjustment Expenses, Claim settlements and reimbursement agreements. Mutual Fire Plan, § I(11) (A88).

While the Plan allows setoff of mutual debts and credits as stated above, Section III(B) precludes setoff of any premium obligations due to Mutual Fire. (A98.) This provision is based upon 40 P.S. § 221.32(b)(4), which expressly prohibits setoff of premium obligations:

> (b) No setoff or counterclaim shall be allowed in favor of any person where:
>
> (4) The obligation of the person is to pay premiums, whether earned or unearned, to the insurer.

40 P.S. § 221.32(b)(4). Section 221.32 applies both to rehabilitations and liquidations. (A19.)

C. SECTION X OF THE PLAN PROTECTS ARBITRATION RIGHTS

In addition, the Plan (Section X) grants discretion to the Commonwealth Court to allow court resolution of claims otherwise subject to contractual arbitration clauses on a case-by-case basis. Contrary to Allstate's assertion that "the party seeking arbitration" is required to obtain Court approval (Petition, p. 5), Section X clearly states that *the party seeking court resolution in lieu of arbitration is required to petition the Court*. (A112.) Moreover, in order to forego arbitration, the Court must make a determination that court resolution "is in the best interest of the estate and will not unduly prejudice any party to the dispute." (Plan, § X, A112.)

D. FINDINGS BY THE COMMONWEALTH COURT AND THE SUPREME COURT OF PENNSYLVANIA

In an Opinion and Order dated January 23, 1990, the Pennsylvania Commonwealth Court (per then President Judge Crumlish) approved, with certain modifications, the Plan submitted by the Rehabilitator and concluded as follows:

> Having considered all objections and found that the proposed Plan, with modifications, constitutes an equitable apportionment of unavoidable loss, is in the best interests of insureds and other creditors, and does not constitute an abuse of the Rehabilitator's discretion, we modify the Plan consistent with this Opinion and approve it in all other respects.

Grode v. Mutual Fire, Marine & Inland Insurance Company, 132 Pa. Commw. 196, 572 A.2d 798 (1990) (A71).

In particular, the Commonwealth Court expressly found that the alleged contractual impairments challenged by Petitioner and other creditors (including rights asserted with respect to collateral, setoff and arbitration) "are, for the most part, insubstantial and do not warrant modification of the Plan except as hereinafter provided." (A52.) The Commonwealth Court then modified Section III(D) and imposed the following additional requirements with respect to setoff:

> (i) the Rehabilitator is to notify creditors of her setoff calculations within 90 days of approval of the Plan;
>
> (ii) creditors have 30 days to object to the setoff calculation; and

> (iii) any dispute over the setoff calculation is to be resolved pursuant to the claim resolution procedures of Section VII of the Plan. (A73.)

The Court also rejected the objections to Section X, and concluded that it simply allows parties to *request* court resolution in lieu of arbitration. (A66.)

Petitioner appealed this decision to the Pennsylvania Supreme Court, arguing that Sections II, III and X of the Plan impermissibly impaired its contractual rights. Petitioner concedes that it did not argue, either in the Commonwealth Court or in the Pennsylvania Supreme Court, that Section X violated the Federal Arbitration Act. (Allstate Petition, pp. 6-7.)

The Pennsylvania Supreme Court rejected the arguments raised by Allstate and the other creditors on appeal. With respect to the questions Petitioner presents for review by this Court, the Pennsylvania Supreme Court made the following specific findings:

> (1) Section III of the Plan "ensures that the creditors herein, at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding," in accordance with *Neblett v. Carpenter*, 305 U.S. 297 (1938). (A19.)
>
> (2) 40 P.S. § 221.32, which establishes what forms of setoff will be permitted, encompasses both liquidation and rehabilitation in Pennsylvania. (A19.)
>
> (3) "Mutual debts and credits" under 40 P.S. § 221.32 are limited to debts which are due and owing (*i.e.*, liquidated, matured) as of December 4, 1986, the date upon which the petition for rehabilitation was filed. (*Foster*, citing

Commonwealth ex rel. Bell v. Tradesmen's Trust Company, 250 Pa. 372, 95 A. 574 (1915).) (A22.)

(4) The "speculative and intangible nature" of case reserves and IBNR at the time of the filing of the petition for rehabilitation "does not warrant their being available for setoff." (A22-23.)

(5) Under Pennsylvania law, setoff is an equitable remedy and accordingly, "is permissive, not mandatory." (A22.)

(6) Allowing reinsurers/cedents to set off obligations that had not matured as of the filing of the rehabilitation petition would result in a windfall. (A23.)

(7) Section III of the Plan satisfied the three-part test set forth by this Court in *Energy Reserves Group, Inc. v. Kansas Power and Light*, 459 U.S. 400 (1983). (A16.)

(8) The Commonwealth Court's approval of Section X(A) was correct. (A36.)

The Pennsylvania Supreme Court also rejected Petitioner Allstate's argument that the Mutual Fire Plan was a *de facto* liquidation which would wind up the company's affairs. (A13-14.) The Supreme Court fully agreed with the Commonwealth Court's conclusion that:

> . . . the ultimate goal of the Plan *is* to have Mutual Fire reemerge as a solvent insurer. The Plan calls for Mutual Fire's possible restructure and orders that it maintain its required capital and surplus minimums required in order to resume operations in the future.

(A14.) Thus, Petitioner is misleading this Court with its repeated characterizations of Mutual Fire as a "defunct"

insurance company and its descriptions of the insolvency proceeding as a liquidation, rather than a rehabilitation.

REASONS FOR REFUSAL OF THE WRIT

Petitioner's argument that the Plan abrogates its alleged contractual arbitration rights in violation of the Federal Arbitration Act was never raised in the state court proceedings. Having waived any constitutional argument on this issue, Petitioner is simply attempting to generate a federal question in a case where none exists.

Petitioner's remaining argument in support of review is premised upon seriously flawed, and unsupported, assumptions. First, Petitioner argues that it would have been entitled to offset "significantly more" of its obligations in a liquidation proceeding. (Petition, p. 24.) This contention is based, not upon any case or statute, but upon Petitioner's "belief" that mutual claims, for purposes of setoff in liquidation proceedings, include case reserves and IBNR. (Petition, p. 9, n.5.) This "belief" is mistaken and as will be discussed, ignores completely the Pennsylvania Supreme Court's interpretation of 40 P.S. § 221.32, the statutory provision governing setoff, and settled Pennsylvania law.[6]

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[6] 40 P.S. § 221.32 provides, in pertinent part, that "mutual debts or mutual credits . . . shall be set off and the balance only shall be allowed or paid, except as provided in subsection (b)." Subsection (b) expressly prohibits setoff where, *inter alia*, (1) the obligation of the insurer to the person seeking setoff would not, at the date of the filing of a petition for liquidation, entitle that party to share as a claimant in the insurer's assets and (4) the

Petitioner's assertions that the Pennsylvania Supreme Court "refus[ed] to apply" this Court's decision in *Neblett v. Carpenter*, 305 U.S. 297 (1938), *reh'g denied*, 305 U.S. 675 (1939), simply make no sense. (Allstate Petition, p. 24). The Pennsylvania Supreme Court's determination that the Mutual Fire Plan satisfied the requirements of *Neblett* could not have been more explicit:

> Under *Neblett*, creditors must fare at least as well under a rehabilitation plan as they would under a liquidation, which [Petitioners] currently argue, would not be the case under this Plan. We disagree. . . . (A14.)

The Court also found that Section III of the Plan complied with the Act's relevant provision regarding setoff (40 P.S. § 221.32), which applies to rehabilitations as well as liquidations. (A19.)[7] Thus, the Court found that, under the Plan's setoff provisions, creditors "at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding, as mandated by the holding of *Neblett, supra.*" (A19.)

Petitioner seeks review of the Pennsylvania Supreme Court's decision approving the Mutual Fire Plan of Rehabilitation because it is dissatisfied with that Court's findings and conclusions with respect to matters of substantive Pennsylvania law. Petitioner would have this

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obligation is to pay premiums, whether earned or unearned, to the insurer.

[7] In fact, the Plan, as modified by the Commonwealth Court, specifically incorporates 40 P.S. § 221.32, removing any doubt that setoff under the Plan is identical to setoff under the Act.

Court substitute its judgment for that of the Pennsylvania Supreme Court in matters involving the interpretation of (1) the Pennsylvania Insurance Department Act and its provisions regulating insolvent insurance companies; and (2) Pennsylvania common law governing "mutual" debts and credits. This Court, which does not sit in appellate review of state court judgments, has consistently refused to exercise its jurisdiction over such matters of substantive state law. *Ridgway v. Ridgway*, 454 U.S. 46, 54 (1981); *Hortonville Dist. v. Hortonville Ed. Assoc.*, 426 U.S. 482, 488 (1976).

With respect to its claim under Article I, Section 10 of the United States Constitution (the "Contract Clause"), Petitioner is asking this Court to assess the Plan's impact upon specific contract provisions (relating to collateral, setoff and arbitration) which are not before the Court and were never made part of the record in the state court proceedings. In any event, the Pennsylvania Supreme Court specifically found that (i) the Plan did not constitute a substantial impairment of Petitioner's contractual rights; and (ii) the Plan (including its provisions relating to secured creditors, setoff and arbitration) served a legitimate and significant public purpose, and was "legitimately designed to ameliorate a financial hazard for the good of all involved." (A17.)

A. PETITIONER HAS WAIVED ANY CONSTITUTIONAL CHALLENGE TO SECTION X OF THE PLAN

In presenting its questions for review, Petitioner contends that Section X of the Plan, which grants the

Commonwealth Court of Pennsylvania the discretion to allow court resolution in lieu of arbitration on a case-by-case basis, abrogates its rights to arbitrate under reinsurance contracts with Mutual Fire, and therefore, violates the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.* However, Petitioner eventually concedes that "[its] brief and oral statement in the Commonwealth Court did not specifically mention the Federal Arbitration Act and its conflict with the McCarran-Ferguson Act. . . . " (Allstate Petition, pp. 6-7.) Likewise, Petitioner admits that it failed to raise this issue before the Pennsylvania Supreme Court:

> Petitioner's brief to the Supreme Court of Pennsylvania restated its objection to the Plan's abrogation of its contractual right to arbitration, *but did not specifically reference the Federal Arbitration Act.* (emphasis added.)

(Allstate Petition, p. 7.)

Obviously, Petitioner Allstate is attempting to fashion a federal question for review by this Court where none exists. As a result of Petitioner's failure to raise these issues, the Pennsylvania courts had no opportunity to pass on the applicability of the Federal Arbitration Act to the provisions of the Plan. *Bankers Life & Casualty Co. v. Crenshaw*, 486 U.S. 71, 76 (1988). Petitioner has clearly waived the argument which it seeks to present concerning a "conflict" between the Federal Arbitration Act and the McCarran-Ferguson Act. (Allstate Petition, pp. 13-22.) As this Court has stated:

> . . . at the minimum . . . there should be no doubt from the record that a claim under a

> *federal* statute or the *Federal* Constitution was presented in the state courts. . . .

Bankers Life, 486 U.S. at 77-78.

In any event, the Plan does *not* abrogate arbitration rights of Petitioner and other creditors, but simply grants the Commonwealth Court the discretion to allow court resolution in lieu of arbitration on a case-by-case basis. Under Section X of the Plan, arbitration will be supplanted only where court resolution is: (1) requested by at least one party; and (2) granted by the court upon a finding that it is in the best interest of the estate, without undue prejudice to any party. (A112.) In approving Section X(A) of the Plan, the Commonwealth Court explicitly stated: "We construe this section as permitting parties to a dispute to *request* Commonwealth Court resolution in lieu of arbitration." (A66.) The Pennsylvania Supreme Court agreed. (A36.)

Moreover, even if Petitioner had properly raised and preserved a challenge to Section X, the issues presented in the Petition are not ripe for review. There has been no suggestion by Petitioner that the Commonwealth Court abused its discretion by denying arbitration in any case, nor has any factual record been developed which could be presented to this Court for review.[8] On the contrary, acknowledging that there is no case or controversy with regard to Section X, Petitioner simply suggests that this issue "needs further refinement" (Petition, p. 12) and in

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[8] In fact, the Rehabilitator filed petitions under Section X seeking court resolution to resolve contract disputes with several reinsurers. These petitions were *denied* by the Commonwealth Court.

effect, is seeking an advisory opinion. Above all, it is properly within the discretion of the Commonwealth Court and within the realm of its jurisdiction, to decide whether court resolution is preferable in any specific instance based upon the best interest of the estate.

B. THE PENNSYLVANIA SUPREME COURT'S DECISION APPROVING THE PLAN DEALS EXCLUSIVELY WITH MATTERS OF SUBSTANTIVE PENNSYLVANIA LAW

The Pennsylvania Supreme Court specifically found that case reserves and IBNR, which are unliquidated and contingent as of the date of the filing of a petition for rehabilitation or liquidation, are not "mutual" *under Pennsylvania law* and hence, not subject to setoff. (A22-23.)[9] That Court also found that any actual contractual impairments arising out of the Plan (including the alleged effects upon security interests, setoff and arbitration claims) were "insubstantial" and, in any event, such Plan provisions were "legitimately designed to ameliorate a financial hazard for the good of all involved." (A15-17.)

Petitioner is simply challenging the Pennsylvania Supreme Court's interpretation of Pennsylvania law with

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[9] By letter dated December 17, 1992, counsel was advised that Allstate intends to file a supplemental brief presenting the case of *Prudential Reinsurance Company v. Superior Court of Los Angeles County*, 1992 W.L. 347585 (Cal. Supreme Court, Nov. 30, 1992). As of this printing, no supplemental brief has been received. If such a brief is filed in this case, Respondent reserves the right to file a supplemental brief in response thereto.

regard to the purpose of the Insurance Department Act and the meaning of "mutuality." This type of challenge is not, and never has been, a basis for seeking review by this Court. In fact, this Court considers itself "bound to accept the interpretation of [state] law given by the highest court of the state," *Hortonville Dist.*, 426 U.S. at 488, and has emphasized that decisions of state courts will be subject to disturbance only to the extent that "they incorrectly adjudge *federal* rights." *Ridgway*, 454 U.S. at 54 (emphasis added).

C. THE PENNSYLVANIA SUPREME COURT EXPRESSLY FOUND THAT THE PLAN SATISFIES THE REQUIREMENTS OF *NEBLETT*

1. "MUTUAL" DEBTS/CREDITS FOR PURPOSES OF SETOFF DO NOT INCLUDE CASE RESERVES AND IBNR

As stated, in considering *Neblett*, the Pennsylvania Supreme Court removed any need to compare setoff rights under liquidation and rehabilitation when it ruled that 40 P.S. § 221.32, which is set forth under the Act's liquidation section, also applies to rehabilitations. (A18-19.)[10] Thus, regardless of whether Mutual Fire is in rehabilitation or liquidation, Petitioner would only be permitted to set off "mutual" debts and credits as provided under 40 P.S. § 221.32.

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[10] The Pennsylvania Supreme Court stressed that § 221.32 begins by stating that its provisions apply to any action or proceeding "under this article." (A19.) The term "article" refers to Article V of the Act, which encompasses both rehabilitations and liquidations. *Id.*

Notwithstanding Petitioner-Allstate's belief that Section 221.32 would permit setoff of case reserves and IBNR (Petition, p. 9, n.5), the Pennsylvania Supreme Court specifically found that a "mutual" debt must be a present, mature obligation as of the date of the filing of the petition for rehabilitation. According to the Court:

> [N]o right of setoff can be available against a note or other obligation that does not mature until after a receiver for the insolvent debtor is appointed. *Commonwealth ex rel. Bell v. Tradesmen's Trust Company,* 250 Pa. 372, 95 A. 574 (1915). *Accord, Appeal of Commonwealth Trust Co. of Pittsburgh,* 324 Pa. 161, 188 A. 200 (1936).

(A22.) The Pennsylvania Supreme Court further concluded that case reserves and IBNR "are not present obligations of the reinsurer":

> Case reserves and IBNR are at most calculations or estimates of future, potential liabilities, which often times are contingent upon a later development or growth of the claim or some intervening procedure such as litigation.

(A22.) According to the Court, the unliquidated nature of case reserves and IBNR at the time of the filing of the petition for rehabilitation "does not warrant their being available for setoff. . . . " *Id.*[11] The Pennsylvania Supreme

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[11] The category of claims allowed to be set off under the Plan (the "due and owing" amounts) were matured, liquidated obligations of Mutual Fire on the date the Commissioner petitioned for rehabilitation. In the context of a reinsurance agreement, the due and owing amount represents the funds already paid by the primary insurance company, which are currently payable to the primary insurer by the reinsurance company. On

Court's interpretation of Pennsylvania law with regard to "mutuality" is not an adjudication of "federal rights" and thus, is not a subject for review by this Court. *Ridgway*, 454 U.S. at 54.

For more than a century, Pennsylvania Courts had relied upon this principle:

> Whatever may be the rights of a party whose debt is due and payable to compel an insolvent debtor to set off a claim against him not due, a party whose debt is not due has no equitable claim to have it set off against a debt of his own already due in the hands of a party who is insolvent.

Dougherty Bros. & Co. v. Central National Bank, 93 Pa. 227, 231 (1880) (citations omitted). This view is still widely accepted. *See, e.g., Liberty Sav. Ass'n v. Sun Bank of Jacksonville*, 572 F.2d 591, 595 (7th Cir. 1978) (" . . . a debt is not subject to setoff unless it has matured. . . . "); *In Re Cabrillo*, 101 Bankr. 443 (E.D. Pa. 1989) (setoff was denied in a bankruptcy proceeding with respect to an installment loan agreement, as opposed to a demand note); *see also FDIC v. Liberty Nat'l Bank & Trust Co.*, 806 F.2d 961, 969

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the other hand, case reserves are merely the primary insurance company's estimates of the amounts which it may expend in the future in defending, settling or otherwise disposing of claims which have been reported to it. Only future events (*e.g.*, a jury verdict) will determine whether additional funds will be expended on any particular claim and, if so, in what amounts. Likewise, IBNR amounts represent an estimate of expenses that *may* be incurred on account of events that have occurred but have not yet ripened into claims or been reported to the primary insurance company.

(10th Cir. 1986); and *Henz v. Superior Trucking Co.*, 96 F.R.D. 219 (M.D. Pa. 1982).

The record in this case amply supports the decision to limit setoff to liquidated due and owing amounts, not loss reserves or IBNR, as of December 4, 1986. At the hearings on the Plan, an expert on behalf of the cedents group (some of whom are Petitioners at Case No. 92-937) testified that, even in non-insolvency situations, the industry-wide practice was to use net balance accounting (*i.e.*, setoff) and that it applied *only* to due and owing balances, not case reserves or IBNR. (T. 489, 537-538.) If setoff as practiced within the insurance industry applies only to due and owing amounts, Petitioner can hardly complain that the same principle in the Plan somehow violates its contract rights.

Not only are the Plan's setoff provisions, as approved by the Pennsylvania Supreme Court, consistent with well-established Pennsylvania legal principles and the factual record, but they also implement the important public policy behind the Act of maximizing protection to policyholders (40 P.S. § 221.1(c).) Thus, the Pennsylvania Supreme Court correctly concluded that allowing Petitioner and other creditors to set off obligations against Mutual Fire that had not matured as of the time of filing the petition for rehabilitation (case reserves and IBNR) would result in a "windfall" to Petitioner not available to policyholders. (A23.)

In addition, the setoff demanded by Petitioner would wreak havoc with the Act's equitable distribution scheme under which innocent third parties (policyholders), who are dependent upon the financial obligations of these

reinsurers to Mutual Fire, have been assigned a priority above that of cedents and reinsurers. As the Pennsylvania Supreme Court observed:

> . . . [T]he exigencies attendant to a major commercial insolvency and the goals of rehabilitation necessitate the reality that "individual interests may need to be compromised in order to avoid greater harm to a broader spectrum of policyholders and the public."

(A15-16), citing *Vickodil v. Commonwealth Insurance Dept.*, 126 Pa. Commw. 390, 559 A.2d 1010, 1013 (1989).

2. THE PLAN'S TREATMENT OF SECURED CEDENTS IS AT LEAST AS FAVORABLE AS IN LIQUIDATION

Contrary to Allstate's assertions, the Plan's treatment of secured cedents' claims and collateral is perfectly clear. Section II(A) of the Plan provides that secured cedents can draw upon their collateral for *the full amount* of their approved claims. The procedure for claims adjustment and approval is clearly set forth in Section VII of the Plan. (A108.)

Should the value of the collateral exceed the amount of the secured cedents' allowed claims, that excess is to be paid to the Rehabilitator. Section II(A) (A91). The term "excess collateral" is clearly defined in the first paragraph of Section II(A) dealing with secured claims generally, to be "any collateral . . . in excess of the amount to which said Secured Creditor is entitled pursuant to this Plan. . . . " (A91.) *See also* 40 P.S. § 221.3. Should the value of the allowed claims exceed the value of the collateral,

the amount of any deficiency will be treated as a Class 6, unsecured claim. Section II(A)(l) (A91).

Until such time as the secured cedents' claims are fully adjusted pursuant to Section VII, the secured cedents necessarily retain their liens against the collateral. Nothing in the Plan abrogates the cedents' security interests.

Thus, the Plan merely provides that the payment to secured cedents from their collateral shall be made by drawing down against that collateral once their claims are finally approved. Through this orderly adjustment of claims, the Rehabilitator can determine her interest in any excess collateral.

Petitioner's argument that the Plan somehow unconstitutionally impairs its rights *vis-a-vis* its collateral is absurd. The requirements for court approval before Allstate can draw against its collateral and that Allstate be permitted to draw against its collateral those amounts due and owing from Mutual Fire, without acceleration, for paid losses and loss adjustment expenses hardly rise to the level of "impairment." (Petition, pp. 9-10.) In any event, Petitioner fails to cite any case or Insurance Act provision to support its contention that its collateral rights are "significantly less favorable" under this Plan than under liquidation. (Petition, p. 24.)

In a liquidation, the Insurance Act (40 P.S. § 221.43) requires that the secured creditors' collateral be valued by conversion into money or by agreement, compromise or litigation. Such a valuation prior to the release or payment of collateral to the secured creditor is obviously necessary to determine the estate's interest in any excess

collateral. Further, the secured creditors' claim or claims must also be determined, as provided in the liquidation sections of the Insurance Act, 40 P.S. §§ 221.38 and 221.41. Only after both the value of the collateral *and* the amount of the secured creditors' claims have been determined can the rehabilitator or liquidator know the value of the estate's interest and take appropriate steps to marshal that value for the benefit of the estate.

The process provided in the Plan for determining the secured cedents' claims and paying them from their collateral is nothing more than a method of valuing the estate's interest and providing for its realization by the estate. Since a secured cedent's full rights in the collateral are maintained by the Plan, Petitioner Allstate cannot be heard to complain about its treatment. Clearly, a slight modification in the procedure for payment from collateral does not amount to a deprivation of due process rights under the rule in *Neblett*.

D. THE SPECIFIC CONTRACT PROVISIONS RELIED UPON BY PETITIONER WERE NOT ENTERED INTO THE RECORD BELOW; IN ANY EVENT, THE PLAN DOES NOT VIOLATE THE CONTRACT CLAUSE

Petitioner has not even attempted to meet its threshold burden of demonstrating that it in fact possesses contractual rights altered by the law. *National Railroad Passenger Corp. v. Atchison, Topeka & Santa Fe Railway Co.*, 470 U.S. 451, 472 (1985). Petitioner claims that it was a party to various reinsurance contracts with Mutual Fire,

which contained provisions concerning security/collateral, arbitration and setoff. (Petition, p. 4.) Then, Petitioner argues that the Plan "severely restricts" each of these provisions. (Petition, pp. 5, 9-10.) However, these crucial reinsurance contracts, which Petitioner insists have been abrogated by the Plan, were never made part of the record in the state court proceedings. These absent contracts, which now are at the very heart of Allstate's request that this Court review the Pennsylvania Supreme Court's decision on the Mutual Fire Plan, were obviously not important enough to warrant their admission as evidence during the course of four days of hearings.

In any event, the Pennsylvania Supreme Court addressed the Contract Clause challenge raised by Petitioner (A15-16) and properly found that the Plan satisfied the three-part test set forth by this Court in *Energy Reserves*. The Pennsylvania Supreme Court found that any actual contractual impairments as a result of the Plan "are insubstantial." (A15.) The Court also concluded, citing the decision of the Pennsylvania Commonwealth Court in *Vickodil, supra*, that the exigencies associated with a major insurance insolvency and the goals of rehabilitation (minimizing the harm to *all* affected parties) "necessitate the reality" that individual interests may have to be compromised "to avoid greater harm to a broader spectrum of policyholders and the public." (A15.)

Inexplicably, Petitioner suggests that the foregoing analysis by the Pennsylvania Supreme Court is faulty because this Court's requirement in *Energy Reserves* that a statute (which substantially impairs contractual rights) serve "a legitimate and significant purpose," is only *dicta*. (Petition, pp. 25-26.) Quite the contrary, it is well settled

that the prohibition in Article I, Section 10 of the United States Constitution against impairing the obligations of contracts "is not to be read literally," *Keystone Coal Assoc. v. DeBenedictis*, 480 U.S. 470, 502 (1987), but must be accommodated to the inherent power of the state "to safeguard the vital interests of its people." *Energy Reserves*, 459 U.S. at 410. The Pennsylvania Supreme Court's decision approving the Plan leaves absolutely no doubt that the Plan provisions being challenged by Petitioner are reasonable and legitimately designed to foster the goals of rehabilitation in Pennsylvania.

Likewise, Petitioner's attempt to separate itself from the gas suppliers in *Energy Reserves* strains credulity. Allstate's argument that the Plan constituted "a sudden and unanticipated retroactive modification" to the commercial expectations of major reinsurers in the United States is difficult to accept. (Petition, p. 25.) The Pennsylvania Supreme Court specifically noted that:

> . . . the objectors to the Plan are members of a highly regulated industry *and as such were well aware of the powers of the Rehabilitator.* (emphasis added.)

(A16, n.4.)

Indeed, the current Pennsylvania Insurance Department Act, in effect since 1977, and decisions issued thereunder, place substantial emphasis upon the broad powers of the Insurance Commissioner, as rehabilitator, "to effectuate equitably the intent of the Rehabilitation statutes, *i.e.*, to minimize the harm to *all* affected parties." (A15.)

Moreover, the National Association of Insurance Commissioners (NAIC) Model Act, upon which the Pennsylvania Insurance Department Act is based, has been in existence for almost 25 years (with the Wisconsin Insurance Law serving as the original model legislation) and is well known to members of the reinsurance industry. Therefore, it is difficult to believe that Petitioner Allstate was surprised in this case.

CONCLUSION

For the foregoing reasons, it is submitted that the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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